

STATEMENT OF JEFFREY N. SHANE
ASSOCIATE DEPUTY SECRETARY
U.S. DEPARTMENT OF TRANSPORTATION

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SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

on

The Future of the Airline Industry

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Chairman McCain, Ranking Member Hollings, and Members of the Committee, I appreciate the opportunity to appear before the Committee to discuss the state of the airline industry and to offer comments on its future.

Improved Aviation Security

Before I begin, however, I would like to reflect for a moment on where we have been since the horrific attacks on our country in September 2001, and the steps that the Department of Transportation has taken to secure airline passengers since that time. One year ago the Transportation Security Administration (TSA) had just been established, yet three very important and challenging congressional deadlines were prominent on our minds – those by which the federal government was to assume responsibility for aviation security, provide federal screeners for all passenger screening, and ensure 100 percent baggage screening at all commercial airports in this country.

In setting those deadlines – and a great many others – in the Aviation and Transportation Security Act, Congress made clear that it would accept nothing less than a major overhaul of our aviation security system, and a dramatic improvement in the quality of security for air travelers. The measures defined in the legislation and the deadlines associated with them were extremely ambitious, leading a great many observers to question whether they were simply beyond reach.

On behalf of Secretary Mineta, I am proud to report that as of last week those deadlines have all been met. The fact that the Department was able to do so is a credit to TSA's leadership and workforce, to the Federal Aviation Administration (FAA), airport and airline communities, and to the contractors that provided critical advice and support in connection with accomplishing the statutory objectives as efficiently as possible. In meeting these deadlines, we have made every one of the nation's more than four hundred commercial airports – and everyone who flies – safer and more secure than they have ever been. We have done so while also providing world-class customer service to the traveling public by treating people with dignity and courtesy. TSA's leadership, and in particular Admiral Jim Loy, have rendered a great service to our nation.

But so have the millions of air travelers whose cooperation -- particularly during the growing pains experienced earlier in the process -- has been instrumental in accomplishing our goal. If all these sacrifices had not been made, we would not have reached our current level of security in the aviation system in such a short timeframe.

Airlines in Distress

Despite the very real success we have enjoyed on the security front, however, the airline industry remains in the midst of the most difficult period of financial distress since it was deregulated almost 25 years ago -- perhaps the most difficult period in modern airline history. The industry has suffered enormous losses for two consecutive years, and will almost certainly experience them again next year. Most airlines continue to incur large financial losses, several airlines are in bankruptcy, including two large network carriers -- US Airways and United -- and several smaller airlines have ceased operating. At the same time, however, a number of low-cost, low-fare airlines have remained consistently profitable.

The terrorist attacks on September 11, 2001, certainly contributed heavily to the industry's losses since that time. But changes underway well before September 11 had already reversed several consecutive years of record profitability. Indeed, the decline in industry profitability for the year ended June 30, 2001, compared with a year earlier, was the largest year-over-year decline ever up to that point in time. These changes had already set the stage for a significant restructuring of the industry, but additional changes are clearly coming. The nature and magnitude of those changes will likely depend on the extent to which large network airlines are able to reduce their operating costs, and the extent to which business travel rebounds as the economy gains momentum.

I should add at this point that while there is reason to be concerned about the current viability of the airline industry, I am not discouraged about its prospects for ultimate recovery. This industry is remarkably resilient. During the early 1990's, a combination of an economic recession and terrorist-related concerns stemming from the Persian Gulf War led to large traffic declines, record losses, and a number of bankruptcies. Yet the airline industry emerged from that period rather quickly, and during the mid-to-late 1990's went through several years of record profits.

Before turning to an in-depth look at the industry's current circumstances and what the future may hold, a brief description of how the operational and competitive structures of the industry have evolved will help us understand the mixed results we are seeing today within the industry, and provide some guidance about likely changes as the industry moves through this very stressful period.

Two very different types of carriers have evolved in the deregulated domestic airline industry we see today -- large network carriers and low-cost carriers. Generally speaking the former are pre-deregulation carriers and the latter are new airlines that evolved after deregulation. To a great extent these two types of airlines serve different types of markets, have different

business strategies, and focus on different customers, even when they operate in the same geographic regions.

Network systems developed by the large pre-deregulation airlines enable them to provide effective, competitive service to small cities within this country and from all U.S. locations to cities of all sizes around the globe. These airlines have higher cost structures and tend to focus on business travelers as their primary customer base. They have focused their operations on serving the needs of this high-yield segment of the market rather than providing capacity for lower-yield, price-sensitive passengers. The substantially lower costs of low-fare airlines enable them to provide capacity for the latter market – price-sensitive passengers – and to price compete for time-sensitive passengers who are otherwise faced with substantially higher prices.

I bring these two sets of characteristics to your attention because of the very divergent experience of these two types of carriers as the industry moves through these hard times, and because of the implications for future change as a result. The financial turmoil of the large network airlines is due in large part to the rapid cost escalation that occurred during the two-year-period preceding September 11, combined with the decline of the business market that their model so heavily relied upon. Today, each of these airlines operates substantially less capacity than before September 11, and after a period of partial capacity recovery in the months after September 11, these carriers are reducing capacity once again.

But while the network carriers are suffering losses and downsizing their operations, the lower cost carriers are earning profits, expanding operations, and gaining market share. This reflects the fact that despite weakened overall demand, the low-fare demand sector is so large that airlines that have sufficiently low costs to allow them to charge low fares and still earn profits continue to experience robust traffic growth.

Recent Financial Performance

The recent financial performance of the airline industry overall is, by any measure, dismal. My testimony today focuses on the performance of the major network carriers, plus a group of low-fare airlines, that together comprise the vast majority of domestic airline operations.

During calendar year 2001, these carriers incurred operating losses of \$10.0 billion on revenue of \$85.8 billion, for a negative operating margin of 11.6 percent. During the fourth quarter alone – immediately following September 11 – these carriers posted a \$4.5 billion operating loss on revenue of \$16.8 billion, a decline of 30.8 percent from the fourth quarter of 2000.

The picture improved somewhat for the first six months of 2002, although very large operating losses (\$4.3 billion) persisted. The pace of the industry's recovery stalled in the second quarter, however, and as a result, losses continued into the third quarter (\$2.3 billion), typically the industry's most profitable. For the first nine months of 2002, these airlines experienced, in the aggregate, a total operating loss of \$6.7 billion. They are likely to

experience further losses in the range of \$2.4 billion for the fourth quarter, bringing total losses for last year to approximately \$9.0 billion.

Looking at financial results on an industry-wide basis does not tell the full story, however. Rather, looking at the results in greater detail reveals markedly different pictures for different types of carriers: large network carriers versus low-fare carriers, and even between the larger network carriers, with the higher-cost carriers reporting much larger losses.

For example, the six largest network airlines reported operating losses of \$10.2 billion for calendar year 2001, and had a negative operating margin of 13.9 percent. The low-fare carriers as a group, by contrast, reported an operating profit of \$0.7 billion, or a positive operating margin of 10.8 percent. It is important to point out that this profitability extended beyond just Southwest. Five of the seven low-fare carriers we examined reported operating profits for 2001. These clear differences between the large network airlines and the low-fare airlines continued throughout the first nine months of 2002.

Similarly, the large network carriers with the highest unit operating costs – American, United and US Airways – reported far larger losses than the other large network carriers throughout 2001 and into 2002. By the third quarter of 2002, while Northwest and Continental were reporting a small operating profit and a small operating loss, respectively, the three higher-cost carriers continued to report very large losses, resulting in negative operating margins ranging from 10.5 percent to 30.3 percent.

Changes in Industry Composition

As I mentioned earlier, large network airlines are reducing capacity while low-cost carriers are expanding operations and increasing market share. Given the thin margins that normally prevail in this industry, even relatively small market share shifts have important consequences. The changes that have occurred during this crisis, however, could have a longer term impact on the make-up of the airline industry.

We are witnessing a large-scale decline in capacity in the mainline operations of large network airlines, a decline that is being replaced only in part by expanded operations of their regional affiliate airlines. For example, comparisons of scheduled capacity – using available seat miles (ASMs) – for the months of March 2001 and March 2003 shows an 18 percent reduction for these carriers, with all six carriers except Northwest reducing capacity by double-digit percentages. While the bulk of this capacity decrease took place between 2001 and 2002, it is continuing into 2003. A slightly different picture emerges, however, when looking at the major carriers' regional affiliates. These carriers also showed capacity reductions between March 2001 and March 2002, but between the March 2002 and March 2003 their scheduled capacity shows an increase of 26 percent.

Scheduled capacity for low-fare carriers, on the other hand, recovered much more quickly after the September 11 attacks. These carriers – including AirTran, American Trans Air, Frontier, JetBlue, Spirit, and Southwest – also experienced capacity reductions immediately following September 11, but by March 2002 their scheduled capacity had more than fully

recovered and was up 13 percent over a year earlier. These carriers' capacity is continuing to increase, resulting in a total increase from March 2001 to March 2003 of 31 percent, with every carrier except Southwest showing a double-digit increase. As a result, the low-fare carriers' ASM share will increase from 12.5 percent in March 2001 to 18.2 percent in March 2003, an increase in market share of almost 50 percent.

The Federal Government's Response

In response to the difficulties faced by the airline industry over the last two years, Congress has passed several important pieces of legislation designed to facilitate recovery. I want to offer a brief progress report on the implementation of these provisions.

Loan Guarantee Program: The Air Transportation Safety and System Stabilization Act established the Air Transportation Stabilization Board (ATSB) to review and decide on applications for loan guarantee assistance, with a total of \$10 billion provided for potential U.S. Government-backed loan guarantees. Sixteen airlines filed applications by the June 28, 2002, deadline, and the ATSB has approved and finalized three loan guarantees to date. The first was a \$380 million loan guarantee to America West Airlines predicated on the carrier receiving a term loan of \$429 million and more than \$600 million in concessions from its shareholders, employees, creditors, and suppliers. In addition, the ATSB also approved and finalized a \$148.5 million loan guarantee for American Trans Air supporting a \$165 million secured loan and a \$40.5 million loan guarantee to Aloha Airlines in support of a \$45 million loan.

The ATSB has conditionally approved three other loan guarantee applications for US Airways, Frontier Airlines, and Evergreen International Airlines, but to date none of the carriers has finalized their loans. US Airways received conditional approval for a \$900 million loan guarantee to support a \$1 billion secured loan. Because US Airways is reorganizing in bankruptcy under Chapter 11, the conditional approval remains in effect subject to the conditions set forth in the Board's July 10 letter to the airline and the bankruptcy court's confirmation of a reorganization plan. The Board will review the reorganization plan when it is presented and determine whether it meets the conditions for issuance of a guarantee. As set forth in the OMB regulations governing the loan guarantee program, final action on the application will be made in conjunction with the carrier's Bankruptcy Court-certified plan for emerging from bankruptcy.

Frontier Airlines received conditional approval for a \$63 million loan guarantee to support a \$70 million loan, subject to the carrier providing additional fees and warrants and completion of final loan documents satisfactory to the Board. Evergreen International Airlines received conditional approval for a loan guarantee of \$90 million in support of a \$100 million loan for that carrier. Similar to Frontier, Evergreen's conditional loan is subject to the carrier providing additional fees and warrants and completion of final loan documents that are satisfactory to the Board. Evergreen's conditional loan guarantee is also subject to resolution of issues related to Evergreen's indebtedness and certain structural and financial enhancements.

The ATSB has rejected seven loan guarantee applications, including those submitted by Vanguard Airlines, Frontier Flying Service, National Airlines, Spirit Airlines, Corporate Airlines, MEDjet International, and Great Plains Airlines. The ATSB was concerned in most of these cases that these applicants' proposals did not provide a reasonable assurance that the carriers would be able to repay the loans, one of the factors the ATSB is required to consider under the OMB's regulations.

In addition, on December 4, 2002, the ATSB decided that it could not approve the proposal of United Airlines for a \$1.8 billion loan guarantee, based on its conclusion that the business plan, as submitted by the company, was not financially sound. United subsequently filed for reorganization under Chapter 11 of the Bankruptcy Act on December 9, 2002, and because the Board never formally rejected or denied United's proposal, the airline can still revise its application with the ATSB. However, as the carrier is now under Chapter 11 bankruptcy reorganization, any approval of a loan guarantee to United could be made only if the guarantee and the underlying financial obligation is part of a Bankruptcy Court-certified reorganization plan for emerging from bankruptcy. Given United's situation, this matter most likely will not be resolved in the near term.

The ATSB is currently examining two other loan guarantee applications from Gemini Air Cargo for \$29.7 million and World Airways for \$27 million.

In summary, of the \$10 billion in loan guarantee authority made available by Congress, loan guarantee applications approved to date, or conditionally approved, represent a total of \$1.6 billion. Applications still pending, together with further consideration of United's application, would represent as much as \$1.9 billion in further loan guarantees. Total potential exposure under the loan guarantee program is therefore likely to be on the order of \$3.5 billion.

Direct Compensation Program: The Air Transportation Safety and System Stabilization Act also provided for \$5 billion in direct compensation to the airline industry. The application of this law extended beyond the large commercial airlines to thousands of smaller direct and indirect air carriers. More than 450 applications for compensation were submitted to the Department and, to date, over 400 air carriers have been paid \$4.6 billion in compensation.

Total compensation provided under this statute is likely to be approximately \$4.7 billion because some carriers didn't incur sufficient losses to qualify them for a full share of the \$5 billion compensation. Most large passenger airlines have received the maximum amount of compensation authorized by Congress. At this time, the only carriers awaiting full payment are those that filed either incomplete or delinquent applications, a small number whose claims continue to be disputed, and small carriers whose compensation was changed by the Aviation and Transportation Security Act.

War Risk Insurance: With respect to war risk insurance, the FAA has been providing third party war risk coverage to U.S. passenger and freight carriers since shortly after September 11, 2001. The Homeland Security Act of 2002 mandates that this coverage be continued and expanded. Specifically, the Act requires that these policies be renewed on the same terms as

the policies that were in effect on June 19, 2002, and that they be expanded to include coverage for hull, passengers and crew. In addition, an air carrier's total premium for all of the coverage can be set at no more than twice the premium in effect on June 19, 2002, and the coverage must begin with the first dollar of any covered loss incurred. Using existing authority – because the Act's provisions are not effective until January 24, 2003 – the FAA implemented these changes when it extended the air carriers' policies on December 15, 2002, for another 60 days. After January 24, the FAA will continue to offer coverage as required by the Act.

Other Programs: In addition to the programs that have been approved by Congress since the September 11 attacks, the Department continues its work in a number of other areas to ensure a healthy aviation industry. For the past several months, teams of individuals from across the Department have been developing potential ideas to include in the Administration's AIR-21 reauthorization proposal, which we intend to submit to Congress later this spring.

We are also continuing our work in promoting safety in the industry. We are mindful of the tragic crash that occurred in Charlotte yesterday and offer our condolences to the families of those individuals involved. Nevertheless, flying on commercial airlines continues to be the safest way for Americans to travel. As you may know, in calendar year 2002, for the third time in the last decade, there were no recorded deaths aboard scheduled commercial aircraft. As Secretary Mineta has pointed out, while we have built unprecedented new levels of security into our system, it also has retained its status as the safest system in the world. We compliment all those involved in ensuring the safety of the flying public, each of whom can take pride in this impressive accomplishment.

Finally, while the congestion experienced in the summer of 2000 seems a rather distant memory, we need to carefully evaluate the capacity that the aviation system will require in the years ahead. One way in which the Department is working to enhance capacity is through an environmental stewardship initiative launched by President Bush last fall. Late last year Secretary Mineta identified the first group of projects, including Philadelphia International Airport's proposed new runway, that have been selected as targets for accelerated environmental review. A number of other airport sponsors have submitted their projects for consideration under this initiative, and we plan to announce another set of targeted projects in the near future.

Industry Outlook

The prospects for revenue recovery in the airline industry will need to be closely watched as carriers continue to recover from the September 11 attacks and as some work to emerge from bankruptcy. If this downturn is like others we have seen in the past, significant revenue recovery will eventually occur, but how much and when remains to be seen. The airlines' recovery has clearly stalled somewhat since early 2002, and industry observers do not expect any significant improvement in the near future.

Other factors further complicate the revenue picture for the large network carriers. First, while a core element of their business model has been the pursuit of high-yield business

travel, studies show that this market is becoming more price sensitive, and it is quite possible that the revenue potential for this portion of the market may have declined permanently.

Second, the decline in business demand coincides with a sharp increase in network airline unit costs, which opens a wider spread between their costs and the costs of their low-fare competitors, several of which are expanding their services. This began in 1999, well before September 11, and even before business travel demand began to collapse in early 2000.

Third, whether or not the business market remains more price sensitive, the ability of the network carriers to charge high fares is gradually being eroded by the expansion of low-fare carriers. Every time a low-fare carrier enters a market with enough service, the ability of the incumbent network carrier to charge business passengers high prices substantially declines. For many years low-fare competition was primarily limited to large, short-distance markets, but this is no longer the case. Low-fare service has been introduced in transcontinental markets by several carriers, particularly JetBlue, and into lower density markets by carriers like AirTran, which now operates a low-fare hub at Atlanta.

The challenge faced by large, networking carriers is clear: the continued profitable growth of several low-fare airlines demonstrates that people still want to fly. While major carriers have been seeking ways to restructure their operations – including capacity reduction, fleet retirement, cancelled or deferred orders for new aircraft, furloughed employees, closed stations, and hub de-peaking – it will take time for such efforts to produce major results. Moreover, absent major reductions in labor costs it is unclear whether these efforts will produce the cost savings necessary for the large network airlines to maintain their current position in an increasingly competitive airline industry.

The coming months clearly will be challenging ones as the airline industry continues to recover from the economic downturn and to adjust to the post-September 11 atmosphere. We have been encouraged by the steps being taken by major carriers to address their cost structures. As a result, the industry model likely to emerge from the current economic cycle will probably not be terribly different from its pre-September 11 predecessor. The success demonstrated by low-fare carriers in recent years, however, could cause more fundamental structural changes in the longer term, especially if the large, network carriers are unable to control their costs.

Conclusion

Mr. Chairman and members of the Committee, thank you for the opportunity to testify here today. I look forward to responding to any questions you may have.